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A DISCUSSION OF THE PUGH CLAUSE:
or, How Well Do You Know the Freestone Rider?

PRESENTED TO:

Presented by:
Roger D. Scales, Of Counsel

The Permian Basin Landmen's Association
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Why are we discussing the Pugh Clause? Don't we all understand it? Maybe not…

A recent quote from a concerned attorney in an oil and gas industry blog:

"It surprises me the number of title attorneys (and landmen?) who do not really understand Pugh Clauses. I often encounter attorneys (and landmen?) who mistakenly think that… any provision resulting in acreage being released after production is a Pugh Clause. A Pugh Clause is a type of retained acreage provision that is only applicable with regards to pooled or unitized lands. A Pugh Clause is completely inapplicable when there has been no pooling or unitization."

Let's Start at the Beginning: *We Have a Problem*

By the early 1900's mineral owners started to become aware of a developing problem.

"Standard form" oil and gas leases allowed Lessees to maintain the entire lease as being held by production ("HBP") beyond the primary term when only a portion of lease (and perhaps only a very small portion) was included in a pooled or producing unit.

This concept is still valid law today…

Texas courts have held that in the absence of specific lease provisions to the contrary, production from any tract in a pooled unit or production unit is to be considered as production from the entire leased premises for the purpose of extending leases beyond their primary term on all the tracts involved.

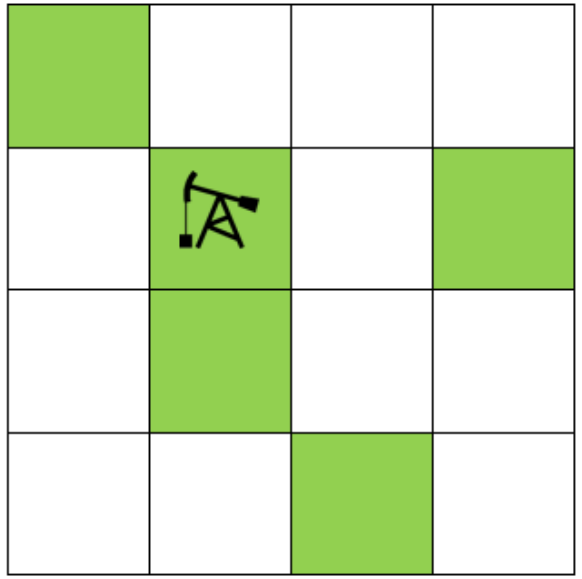
The typical oil and gas lease with a pooling clause provides that the entire lease tract will be considered held by production, regardless of whether that production is on the pooled area or on some area of the tract that has not been unitized.

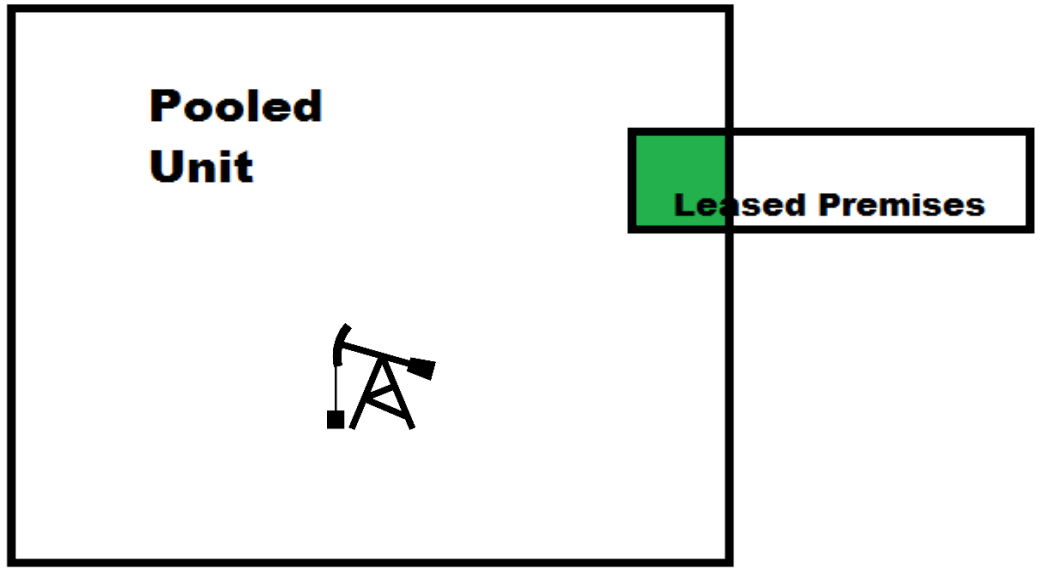
Shown v. Getty Oil Co., 645 S.W.2d 555 (Tex. App. San Antonio 1982).

The Doctrine of Indivisibility

This concept has sometimes been referred to as the “Doctrine of Indivisibility”, which means that a single well (which could be on the lease itself or on a pooled unit to which any part of the lease has been included), which is capable of producing in paying quantities, will maintain the entire lease (even if the leased lands were not contiguous) into the secondary term as to all depths, unless the lease itself contains a provision requiring partial termination of the lease.

Typical Examples of the Problem





(1) One lease covers multiple tracts, and one producing well on one tract maintains all tracts HBP, and

(2) Pooled Unit only includes part of leased premises, but one producing well in pooled unit maintains entire leased premises HBP.

Lessor's Lost Income

As a result, mineral owners suffered lost income a
these non-producing lands were still considered
HBP and therefore were unavailable for new lease
and the resulting bonus payments, rentals, and
potentially, royalty payments.

Further, the royalties that the lessor was receiving
were reduced (sometimes significantly) by the
proportion of their leased lands in the larger
pooled unit.

As expected… litigation followed

Lessors began to file lawsuits demanding release of these lands outside of the pooled unit or production unit once the primary term had expired.

In these early days, their best recourse was to claim breach of *the Implied Covenant to Develop the Premises.*

Was relying on the protections of the Implied Covenant to Develop the Premises a reasonable answer to the problem?

Let's consider the basis for the Implied Covenant to Develop the Premises and the three duties of the covenant…

Basis for the Implied Covenant to Develop the Premises

Texas courts based the implied covenant to develop upon the fact that Lessor royalties on production (as opposed to bonus, rentals, etc.) were the principal consideration for granting the lease.

The covenant therefore supports the presumed intent of the Lessor and Lessee that the lease will be adequately drilled and developed so that the Lessor can receive its expected revenue.

The Three Duties of the Implied Covenant to Develop the Premises

(1) The Duty to Drill an Initial Well:

This duty arose from the early oil and gas leases which often had very long fixed terms. Noting that a long delay in drilling would deprive the lessor of royalty income (which was the principal consideration received for executing the lease), the courts implied a duty to drill an initial test well within a reasonable time.

The advent of relatively short primary terms, delay rental payments, and other provisions found in modern leases have generally rendered this duty obsolete.

Duties (continued)

(2) The Duty of Reasonable Development:

Timing: Arises once oil or gas production in paying quantities has been obtained from the leased premises, or lands pooled therewith, but cannot arise during the primary term as may be extended by delay rentals;

Profit / RPO Requirement: Generally, the Lessee has no duty to drill additional development wells unless there is a reasonable expectation of profit and a reasonably prudent operator would do so;

Area / Depths: This element focuses on full development of the horizons or areas where producing wells are located, although some Texas cases indicate it also applies where no production has been established if certain elements are present. For example, *Clifton v. Koontz* suggests that profitability from drilling need not be shown "where the lease covers several thousand acres and an effort is being made to hold such vast acreage by showing production from a comparatively small area".

Diligence in Development: In order to establish breach of this element, the Lessor must show that the Lessee has not proceeded in the development of the leased premises as a reasonably prudent operator would in a diligent, timely manner.

Duties (continued)

(3) The Duty of Further Exploration:

Imposes upon the Lessee an obligation to explore undeveloped portions (areas or horizons) of its lease for new, potentially productive formations. The Lessor establishes breach by showing facts such as long delay without drilling, minimal drilling compared with the size of the tract, and lack of seismic or other exploratory activities. Lessor is not required to prove that any particular well will be profitable to drill.

Under this definition, the exploration duty differs from the implied duty of reasonable development in that the latter is concerned with known, producing formations and additional drilling can be required only upon a showing that specific wells can be drilled with a reasonable expectation of a profit.

Generally speaking, Texas courts do not recognize an implied duty to explore apart from the implied duty of reasonable development.

Clifton v. Koontz, 160 Tex. 82, 325 S.W.2d 684 (1959);

Sun Oil Exploration & Production Co. v. Jackson, 783 S.W.2d 202 (Tex. 1990).

Was reliance on the Implied Covenant of Development a Viable Solution to the Lessor's Problem?

The implied covenant of development is fully recognized by Texas courts, however, proof of breach is difficult and expensive, and trial court judgments are rarely upheld.

Usually any remedy granted is in the form of damages, and lease cancellation is typically reserved for cases of extraordinary circumstances.

Therefore, reliance on this covenant alone was not effective.

The Case that Inspired the Solution: Hunter v. Shell Oil

These conditions existed until the mid-1940's, when the Louisiana Supreme Court issued its verdict in the case of Hunter v. Shell Oil Co., 211 La. 893 (1947).

In this case, Lessor had executed two leases covering several separate tracts of land in Sections 5 and 8, Township 11 North, Range 14 West, DeSoto Parish, Louisiana.

The portion of the leased lands located in Section 5 (and not Section 8) were force-pooled with several other tracts in Section 5 by the Louisiana Commissioner of Conservation.

No well had been drilled on any part of the leased premises, but a producing gas well had been drilled and completed on non-lease lands which had been force-pooled with a portion of the leased lands.

After the primary term of the leases expired, the Lessor filed suit to have the lands outside of the pooled unit released.

Issue and Holding

Issue Before the Court: When an oil and gas lease covers land both within and without a pooled unit during the primary term of such lease, and when production in paying quantities is secured while such lease is in effect from a well within the pooled unit but not on any portion of the leased land, does such production maintain the lease in effect beyond its primary term as to the part of the land leased which lies outside such unit?

Holding: The Court held that production from a unit including a portion of a leased tract will maintain the lease in force as to *all lands* covered by the lease, even if they are not contiguous.

Court's Reasoning

"The law is well settled that the lessee's obligation to drill a well is indivisible in its nature, and that the grantor's corresponding obligation to deliver the land is likewise indivisible, and that, if the obligation of one of the parties to the contract is to be fulfilled entirely, the obligation of the other contracting party must likewise be fulfilled in whole….

Plaintiff is receiving the same royalties from the well drilled in Section 5 (non-leased lands) as it would receive if the well had been located upon the leased premises…, and there has been, in effect, since the obligation of the lease was not divided, production in paying quantities from the entire leased premises situated both in Section 5 and in Section 8 within the primary term of the lease, which prevents its expiration at the end of its primary term."

The Solution!

Remember, courts have held that in the absence of specific lease provisions to the contrary, production from any tract in a pooled unit or production unit is to be considered as production from the entire leased premises for the purpose of extending leases beyond their primary term on all the tracts involved.

Apparently in reaction to the Hunter v. Shell ruling, Lawrence Pugh, Sr., an attorney from the small town of Crowley, Louisiana, concluded that the only way to protect his clients from the verdict reached in the Hunter case was to draft a special lease provision to address the problem.

As a result, Pugh has been widely credited with drafting one of the earliest, if not the first such clauses attempting to deal with the ruling in Hunter.

His clause, and later versions of it, came to be commonly known as the **"Pugh Clause"**.

Who was Lawrence Pugh?

Consider this: *How many people can you think of who have a commonly used oil and gas lease provision named after them?*

Lawrence G. Pugh, Sr. was born in Crowley, Louisiana in 1895 and died there in 1966. He was a lieutenant in the United States Army, serving in France during World War I. Following the war, he earned a law degree from LSU and went on to practice law in Crowley, first with his father and then with his own firm for the rest of his career. He was widely known for his legal work in mineral leasing and royalty issues. His son and grandson also became lawyers in the State of Louisiana.

Images of Lawrence Pugh

Rarely seen family picture of
Lt. Lawrence Pugh in France
during World War I,
during the winter of 1917-1918
(He was about 23 years old)

(courtesy of Lawrence G. Pugh, III)

Lawrence Pugh
in his Crowley,
Louisiana office,
December 3, 1922

So, what is a “Freestone Rider”?

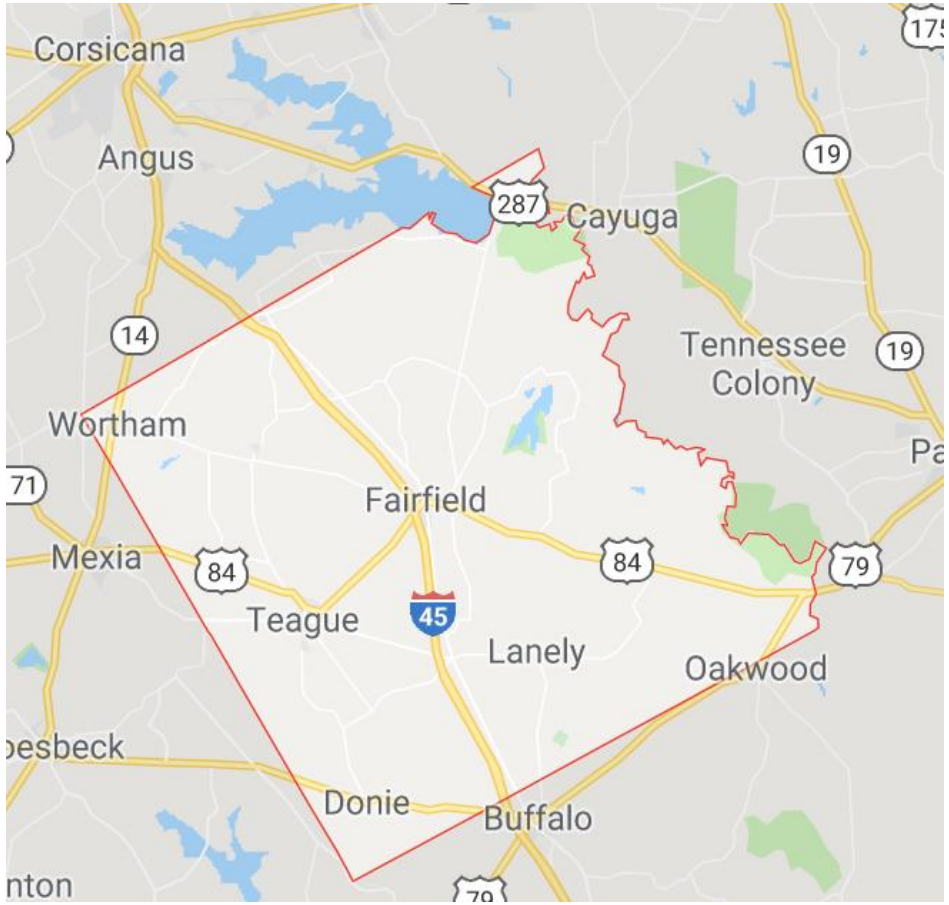
Not this guy.

For you young ones, that’s Peter Fonda from the 1969 film “Easy Rider”.

Texas attorneys and Lawrence Pugh had similar thoughts…

Clauses similar to the Pugh Clause began showing up in leases in Freestone County, Texas (located southeast of Corsicana) around the same time, which led to this type of clause also becoming known as a "**Freestone Rider**".

However, the term "Pugh Clause" is now more universally accepted.



What is the Pugh Clause and what does it accomplish?

In general terms, the Pugh Clause provides that production from a unitized or pooled area located on or including a portion of the leased lands will not be sufficient to extend the primary term for the ***entire*** leasehold. If the lessee takes no actions to extend those portions of the lease outside of the pooled or unitized portion of the leased lands (such as continuous development, payment of delay rentals, etc.), the lease will expire as to these excluded lands.

Shown v. Getty Oil Co., 645 S.W.2d 555, 560 (Tex. App.—San Antonio 1982)

In other words, the main purpose of any Pugh clause is to protect the lessor from the anomaly of having the entire property held under a lease by production from a very small portion.

Rogers v. Westhoma Oil Co., 291 F.2d 726 (10th Cir.1961)

Application to Production Units

It should be noted that Pugh clauses can be used where no pooling is involved. Sometimes referred to as a type of "retained acreage" clause, they provide that a well will maintain only the unit assigned to it, and the lease will terminate as to all unproductive or undrilled leased acreage. Such clauses, which can also be used to accomplish a vertical severance or a horizontal severance or both, are often accompanied by a "continuous development" clause specifying that the lease will not terminate as to undrilled acreage if the lessee commences drilling a new well within a specified time after finishing drilling its most recent well.

Cmty. Bank of Raymore v. Chesapeake Exploration, LLC, 416 S.W.3d 750 (Tex. App.—El Paso 2013)

Who Benefits from the Pugh Clause?

The Pugh Clause is generally considered a benefit to the lessor, in that non-producing portions of their land will not be considered HBP and will instead be released, allowing them to potentially re-lease these lands and obtain bonus, rentals, and royalties that would otherwise not be forthcoming.

The clause may be considered a detriment to the lessee, in that they can no longer maintain the lease as HBP by virtue of any portion of the leased premises being in a producing unit.

Since Pugh Clauses work primarily to the benefit of the lessor, they usually appear in lessor-drafted lease forms, lessor proposed addenda, or are otherwise included at the insistence of the lessor or their attorneys.

Is there a standard Pugh Clause?

Although the Pugh Clause is a fairly common provision in many leases today, there is no "industry standard" Pugh Clause in Texas (although Oklahoma, North Dakota, Mississippi, and Arkansas have established "statutory" Pugh Clause rulings).

As a result, the many variations of the Pugh Clause can provide unpleasant surprises to both lessors and lessees who assume that all Pugh Clauses operate similarly.

It is therefore critical that landmen and attorneys understand how the Pugh Clause in each lease operates and how it may impact other clauses in the lease (particularly, continuous drilling and retained acreage clauses). Further, with drilling schedules being altered, postponed, or shifted on a regular basis, it is of high importance that we understand when Pugh Clauses will necessarily cause leasehold to expire.

Surface Area Pugh Clauses

The first Pugh Clauses were **Surface Area Pugh Clauses**, essentially created to cause the release of acreage based on surface area, stating that following the expiration of the primary term, or any extensions thereof as provided for under the lease, the lease would expire as to all acreage not included in a pooled unit or producing unit. That portion of the lease within the area included in the pooled unit or producing unit, from the surface to all depths, would be maintained HBP.

An example of a Surface Area Pugh Clause:

"Production from or operations on a pooled unit or units including a portion or portions of the leased premises will maintain this Lease in force only as to the acreage included in the unit or units. On acreage not included in a unit or units, the Lease may be maintained by any of its other provisions."

Depth Pugh Clauses

Surface Area Pugh Clauses allow the lessee to maintain non-producing formations that might be productive but weren't being developed.

This led to the development of the **Depth Pugh Clause**, which typically provided for lease expiration either (a) below the deepest producing zone or (b) as to non-producing formations.

With the advent of horizontal wells, these clauses also commonly act to release depths above and/or below the actively producing formation(s).

Depth Pugh Clause (Continued)

Two common examples of a Depth Pugh Clause:

"At the expiration of the primary term of this lease or at the end of the extended period for continuous development provided below, whichever is later, this lease shall also terminate as to all rights, strata and horizons situated below one hundred feet (100') below the stratigraphic equivalent of the deepest depth drilled in a well or wells drilled, producing and located on the leased premises or on lands pooled therewith."

"The production of oil or gas from any formation, zone, or horizon in and under a pooled oil unit or a pooled gas unit formed pursuant to the printed provisions of this Lease will maintain this Lease only as to that portion of the lease premises located within the pooled unit and only as to the formation, zones, or horizons from which production is being obtained. This Lease may be perpetuated as to nonproductive formations, zones, and horizons, and that part of the lease premises located outside of the pooled unit under other provisions of this Lease."

Is it a Vertical or Horizontal Pugh Clause – and how are these terms defined?

Some industry organizations, courts, and reference materials refer to a Surface Area Pugh Clause as a "Vertical Pugh Clause" (AAPL; NARO; Schlumberger Oilfield Glossary; Sandefer v. Duhon, 961, F 2nd 1207, Court of Appeals, 5th Cir., (1992)). This definition appears to have gained more traction in recent years.

However, others refer to a Surface Area Pugh Clause as a "Horizontal Pugh Clause" (see Roseberry v. LL&E, 470 So. 2d 178 (La. Ct. App. 1985)).

Is it a Vertical or Horizontal Pugh Clause – and how are these terms defined? (continued)

In exactly opposite fashion, some industry organizations, courts, and reference materials refer to the Depth Pugh Clause as a "Horizontal Pugh Clause" (see Questar Exploration and Production Co. v. Woodard Villa, Inc. et al., Court of Appeals of Louisiana, Second Circuit, 123 So.3d 734 (2013)).

Others refer to the depth Pugh Clause as a "Vertical Pugh Clause" (see Roseberry v. LL&E Co.).

How to deal with the confusion…

As a result, we cannot rely on anyone simply saying that the Pugh Clause in the lease is a "Vertical Pugh Clause" or a "Horizontal Pugh Clause" and then assume what that means.

We must instead read and understand the language in the clause to determine whether it is an Surface Area Pugh Clause or Depth Pugh Clause.

One landman's opinion…

A longtime landman and brokerage firm manager said:

"Many land professionals are confused about what is a vertical and what is a horizontal pugh clause. LEGALLY – a vertical pugh clause is one where all acreage outside of the well/unit boundaries must be released. LEGALLY – a horizontal pugh clause is one where you must release acreage below a certain depth. However, these two terms are used interchangeably in the industry. The way I teach my students is this, if you wrap your arms around the unit and chop down (vertically) then it is a vertical pugh clause. If you go down the drill hole and chop across (horizontally) then that is a horizontal pugh clause. Silly, but it helps you to remember and get it right. Don't fret though, even a lot of attorneys have a misunderstanding of this one."

Cathaleen D. Pettigrew, President

Pettigrew and Pettigrew Land Services, Houston, Texas

Helpful practical advice!

In response to Ms. Pettigrew's statement, Randy Young wrote in his blog for LandmanInsider.com:

"This is not the way many of us have been taught, and this is not the way that many operators consider pugh clauses to be defined, which can lead to some confrontations if you start telling your client they don't know what a vertical pugh is. The solution I've come up with is whenever the 'definition' of a vertical or horizontal pugh might matter, for instance when you are entering their lease data into their land system — I now always ask what <u>they</u> call a horizontal and vertical pugh. Then I typically suggest changing their provision coding data to read "Horizontal Pugh (Depth)" and "Vertical Pugh (Acreage)". If their definition is the opposite of that, then I suggest changing it to read "Vertical Pugh (Depth)", etc. In my opinion, this is the best way to handle the issue."

Wellbore Only Pugh Clause

The wellbore only Pugh Clause releases all acreage outside the wellbore after the primary term and extensions expire.

This type of Pugh Clause has been a more recent development and it is typically coupled with a depth Pugh Clause.

The wellbore only Pugh Clause is typically seen only on leases that reflect a large acreage position in a lucrative field which gave the landowner significant negotiation power in lease negotiations.

The Pugh Clause and Horizontal Wells

With the advent of horizontal wells, Pugh Clauses have been modified to accommodate the horizontal drilling and completion process.

Many mineral owners have attempted to obtain Pugh Clauses that release all acreage outside of the horizontal strip drained by the hydraulic fracturing process, conceptually akin to a wellbore only Pugh Clause for a vertical well. The actual language used for these clauses can vary greatly with some clauses creating complex formulas including length of the lateral line to determine acreage allocation for each horizontal well. Other clauses simply establish a stated amount of acres to be allocated around each horizontal well's lateral line.

Depth Pugh Clauses may also be added to restrict acreage to the target zone or zones. When a shale play acreage includes possible vertical well drill sites as well, the issue of Pugh Clauses becomes further complicated.

CAUTION: The way that Pugh Clauses have been drafted by mineral owner attorneys to make traditional vertical well concepts customized to horizontal drilling has led to many variations that require close reading to fully understand each time a new variation is encountered.

The Pugh Clause and the Express Development Clauses

We determined that the Implied Covenant of Development alone was not adequate to solve our problems of less-than full development of leased acreage.

Lawrence Pugh came up with the Pugh Clause, which has been modified and refined to suit our purposes, to include many variations on vertical, horizontal, wellbore, and horizontal well Pugh Clauses.

Most leases now include “express development clauses” in conjunction with the Pugh Clause.

The express development clauses generally fall into two categories:

(1) Continuous Development Clauses and

(2) Retained Acreage Clauses.

Pugh Clause vs. Retained Acreage Clause

Generally speaking, the Retained Acreage Clause is a lease provision that authorizes the lessee to retain an agreed amount of acreage around a producing well or producing unit after the balance of the lease automatically terminates, which may occur at the end of the primary term or at the end of continuous development.

This clause is closely related to the Pugh Clause. However, the Retained Acreage Clause does not require pooling in order to be effective.

Pugh Clauses have sometimes been referred to as a type of Retained Acreage Clause.

Pairing the Pugh Clause and the Retained Acreage Clause

Retained acreage clauses are often paired with "depth pugh" clauses in order to limit the amount of depths that a Lessee can maintain under lease after the expiration of the primary term.

Pairing the Pugh Clause with the Continuous Development Clause

Here is an example of a Pugh Clause triggered at the end of primary term as may be extended by continuous development:

"At the expiration of the Primary Term or the conclusion of the continuous development program, this Lease shall terminate as to all of the leased Oil and Gas rights in all formations below the depth of 100 feet below the stratigraphic equivalent of the base of the deepest formation from which the Lessee is then producing Oil and/or Gas in paying quantities from a well or wells located on such proration or producing unit."

Community Bank of Raymore v. Chesapeake Expl., L.L.C., 416 S.W. 750 (Tex. App.—El Paso 2013, no pet.)

CAUTION to the Author and the Reader!

Extreme care must be used in drafting and understanding lease provisions that attempt to combine a Pugh Clause with a continuous development or retained acreage clause in the same provision.

Lack of clarity can often occur if the size of the retained acreage units is tied to that of Railroad Commission units. Draftsmen commonly fail to distinguish among voluntarily pooled units, proration units, and drilling units.

Ambiguous language can result in the termination of more acreage than anticipated by the lessee, less acreage than anticipated by the lessor, or create serious problems of interpretation over exactly what acreage has terminated and what acreage is maintained.

A Few Select Cases involving the Pugh Clause

Albert v. Dunlap Exploration, Inc.
El Paso Prod. Oil & Gas v. Tex. State Bank
Community Bank of Raymore v. Chesapeake Expl. LLC
Hardin Simmons Univ. v. Hunt Cimmaron LP
Sandefer Oil & Gas, Inc. v. Dubon

Albert v. Dunlap Exploration, Inc.
457 S.W.3d 554; 2015 Tex. App. Lexis 1402; 183 Oil & Gas Rep. 625

Lessors executed two leases covering two adjacent tracts which were later pooled.

Lease "A" had a vertical (surface area) and horizontal (depth) Pugh Clause.
Lease "B" had no Pugh Clause.

Following various assignments and farm-outs, the parties executed a ratification agreement that contained an addendum. The addendum provided for proration units to be set aside for existing wells and wells yet to be drilled, specifying completion depths far below the Pugh Clause depths set out in Lease "A". The addendum had the typical language stating that in case of conflict between the terms of the leases and the addendum, the terms of the addendum would rule. Because of the ambiguity and conflict between the terms of the Pugh Clause in Lease "A" and the addendum to the ratification, the Court held that the addendum acted to negate the lease Pugh Clause.

What to take from this case: Be sure to consider how the terms of the entire lease and any ratifications, addenda, etc. might affect the validity of the Pugh Clause.

El Paso Prod. Oil & Gas v. Tex. State Bank

2007 Tex. App., Lexis 1946, 2007 WL 752209

In 1948, Lessors executed two leases covering approx. 1,700 acres.

Over time, the leases were pooled into Units A, B, C, and D, with each unit being limited to depth horizons stated in the pooled unit declarations.

Continuous drilling ceased. The dispute was then whether the Pugh Clause language acted to maintain the pooled units as to all depths or only the depths stated in the pooled unit declarations.

The lease used the word "lands" in the granting clause and elsewhere to refer to the surface area and all depths below. The lease defined "developed acreage" as lands covered by the lease which were then allocated in a production unit or a pooled unit for a well producing in paying quantities.

The key language in the Pugh Clause was, "The lease shall remain in effect as to all depths as to all developed acreage so long as there is production of oil and/or gas in paying quantities from said developed acreage."

El Paso Prod. Oil & Gas v. Tex. State Bank (cont.)

Lessee argued that the terms of the lease did not distinguish between depths when determining how the lease terminates. They argued that the retained acreage was the “lands” (meaning all depths) included in a pooled unit.

Lessor argued that the Lessee voluntarily created pooled units, which were depth restricted, by their very nature would not allow production from depths not included in the pooled unit, and therefore the retained leasehold should be limited to the surface area as well as the depths of the pooled units.

El Paso Prod. Oil & Gas v. Tex. State Bank (cont.)

Holding: The Court agreed with the Lessee, holding that the use of the word "lands" referred to surface acreage and all depths, and that the use of the phrase "all depths" would have been unnecessary if the developed acreage was equivalent only to the depths covered by the pooled gas units.

What to take from this case: Words matter! Be very clear about the leasehold that will be retained or released, and whether a Pugh Clause is intended to release vertical, horizontal, or both. Note that words such as "lands", "lease premises", and "number of acres" are interpreted as meaning "surface acres".

(see also Friedrich v. Amoco Production Co., 698 S.W.2d 748, Tex. App. - Corpus Christi, 1985)

Community Bank of Raymore v. Chesapeake Expl., L.L.C.,
416 S.W. 750 (Tex. App.—El Paso 2013, no pet.)

At the expiration of the Primary Term **or** the conclusion of the continuous development program, this Lease shall terminate as to all of the leased Oil and Gas rights in all formations below the depth of 100 feet below the stratigraphic equivalent of the base of the deepest formation from which the Lessee is then producing Oil and/or Gas in paying quantities from a well or wells located on such proration or producing unit."

Lessor argued that the lease terminated as to depths below 5,762 feet (the base of the deepest producing formation) at the end of the Primary Term because of the use of the word "or" in the Pugh Clause.

Community Bank of Raymore v. Chesapeake Expl., L.L.C. (cont.)

Holding and what to take from this case: The Court rejected Lessor's argument, and held (1) that Lessee had continuously developed the lease with no lapse in the time period, (2) that Lessor's interpretation would fail to give effect to the lease's continuous development and retained acreage clauses, which control what happens to undeveloped acreage at the end of the primary term, and (3) it would make little commercial sense to interpret the clause in Lessor's way, because part of the horizontal Pugh's purpose is to encourage the Lessee to continue to develop the property in order to retain all the leased acreage and depths. That incentive disappears if the lease is interpreted in a manner that allows undeveloped portions to expire even when the lessee is engaged in continuous development.

Hardin Simmons Univ. v. Hunt Cimmaron LP

2017 Tex. App. Lexis 6934, 2017 WL 3197920

The lease in this case provided a Pugh Clause which stated that, subject to the other terms and provisions of the lease, the lease would terminate at the end of the primary term except for lands included in a production unit.

The lease also provided a continuous development program, which could have maintained the entire lease beyond primary term as to all lands and depths.

The lease also had a reworking clause, which provided that if the lessee was engaged in reworking any well on the leased premises, that the lease would be maintained in accordance with its terms.

There was no new drilling at the end of the primary term, but there were reworking operations taking place.

Hardin Simmons Univ. v. Hunt Cimmaron LP (cont.)

Holding and what to take from this case: The Court held that the language "in accordance with its terms" as opposed to "being maintained as to all lands and depths" meant that the Pugh Clause and the Retained Acreage clauses applied to the reworking clause, and the only leasehold that was retained was that found in the production units (the reworked wells).

Sandefer Oil & Gas, Inc. v. Dubon

961 F.2d 1107, 1209 (5th Cir. 1992)

Lease had a Pugh Clause which stated that after expiration of the primary term, the lease was to terminate as to all horizons situated 100 feet below the deepest depth drilled from which a well located on the land or acreage pooled therewith is producing in paying quantities.

Lessee drilled to 17,609 feet, but its production was from a perforation between 17,090 and 17,200 feet (in the "Upper Formation").

The well was drilled deep enough to be completed in the "Lower Formation", but it was not completed in the Lower Formation.

All production was from the Upper Formation.

Lessor demanded release of the lease as to depths below 17,300 (100 feet below the deepest producing zone, but Lessee refused, arguing that the language of the Pugh Clause allowed them to retain to depths 100 feet below the deepest depth drilled, being 17,709 feet, regardless of what depths the well was producing from.

Sandefer Oil & Gas, Inc. v. Dubon

Holding : The Court agreed with the Lessor, stating that the bottom of this well at 17,609 feet is simply not a depth from which a well is producing in paying quantities. Therefore, this lower depth does not satisfy all of the criteria detailed in the lease. They illustrated their logic by example: What if the well had been drilled to a depth of 17,800 feet, with a perforation resulting in a producing well in a 200-foot sand located just below 4500 feet. Is the additional two and one-half miles of depth to be maintained under the lease, without any further development, as long as the sand at 4500 feet surrenders its oil or gas in paying quantities? We are not so persuaded.

What to take from this case: When a horizontal Pugh Clause maintains the lease to the deepest depth drilled from which a well s producing in paying quantities, the deepest depth is the deepest depth from which production is established, not any deeper non-producing depth.

May we assist you? Here's how to reach us…

Roger D. Scales
Of Counsel
713.653.7308
rscales@coatsrose.com

Connect with me on LinkedIn!

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